

# **Bank Compliance Group Seminar**

**December 2010**

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Department of Financial Institutions**

# Topics for Discussion

- Update on Condition of the Industry
- Observations on the Outlook for the Economy & Banking Conditions
- Where Do We Go from Here with Bank Regulation and Supervision?

# State / National Bank Comparison

## California Headquartered Institutions

(as of 9/30/10)

<u>Asset Size</u>	<u># State</u>	<u>% of Total</u>	<u># Nat'l</u>	<u>% of Total</u>
< \$100MM	31	15%	6	12%
\$100MM to \$500MM	117	57%	34	66%
\$500MM to \$2B	39	19%	4	8%
<u>\$2B and &gt;</u>	<u>19</u>	<u>9%</u>	<u>7</u>	<u>14%</u>
Total	206	100%	51	100%

# State / National Bank Comparison

Total Asset Size  
(as of 9/30/10)

<u>Asset Size</u>	<u>State Banks</u>	<u>% of Total</u>	<u>Nat'l Banks</u>	<u>% of Total</u>
< \$100MM	\$2.3B	1%	\$339M	0%
\$100MM to \$500MM	\$27.2B	11%	\$7.0B	4%
\$500MM to \$2B	\$39.3B	15%	\$4.0B	3%
<u>\$2B and &gt;</u>	<u>\$186.3B</u>	<u>73%</u>	<u>\$154.6B</u>	<u>93%</u>
Total	\$255.0B	100%	\$166.0B	100%

# 10 Largest US BHCs 1960 vs. 2010

1960

Institution	Total assets (USD billions)	Assets as a percentage of GDP (percent)	Assets as a percentage of total banking sector assets <sup>(b)(c)</sup> (percent)
Bank of America	11.2	2.1	4.4
Chase Manhattan Bank	8.4	1.6	3.3
First National City Bank of New York	8.2	1.6	3.2
Manufacturer's Hanover Trust Company <sup>(e)</sup>	5.9	1.1	2.3
Morgan Guaranty Trust Company	4.1	0.8	1.6
Chemical Bank New York Trust Company	4.1	0.8	1.6
Security First National Bank	3.4	0.7	1.3
Bankers Trust Company	3.1	0.6	1.2
First National Bank of Chicago	3.0	0.6	1.2
Bank of California	0.7	0.1	0.3
<i>Total</i>	<b>52.1</b>	<b>9.9</b>	<b>20.3</b>

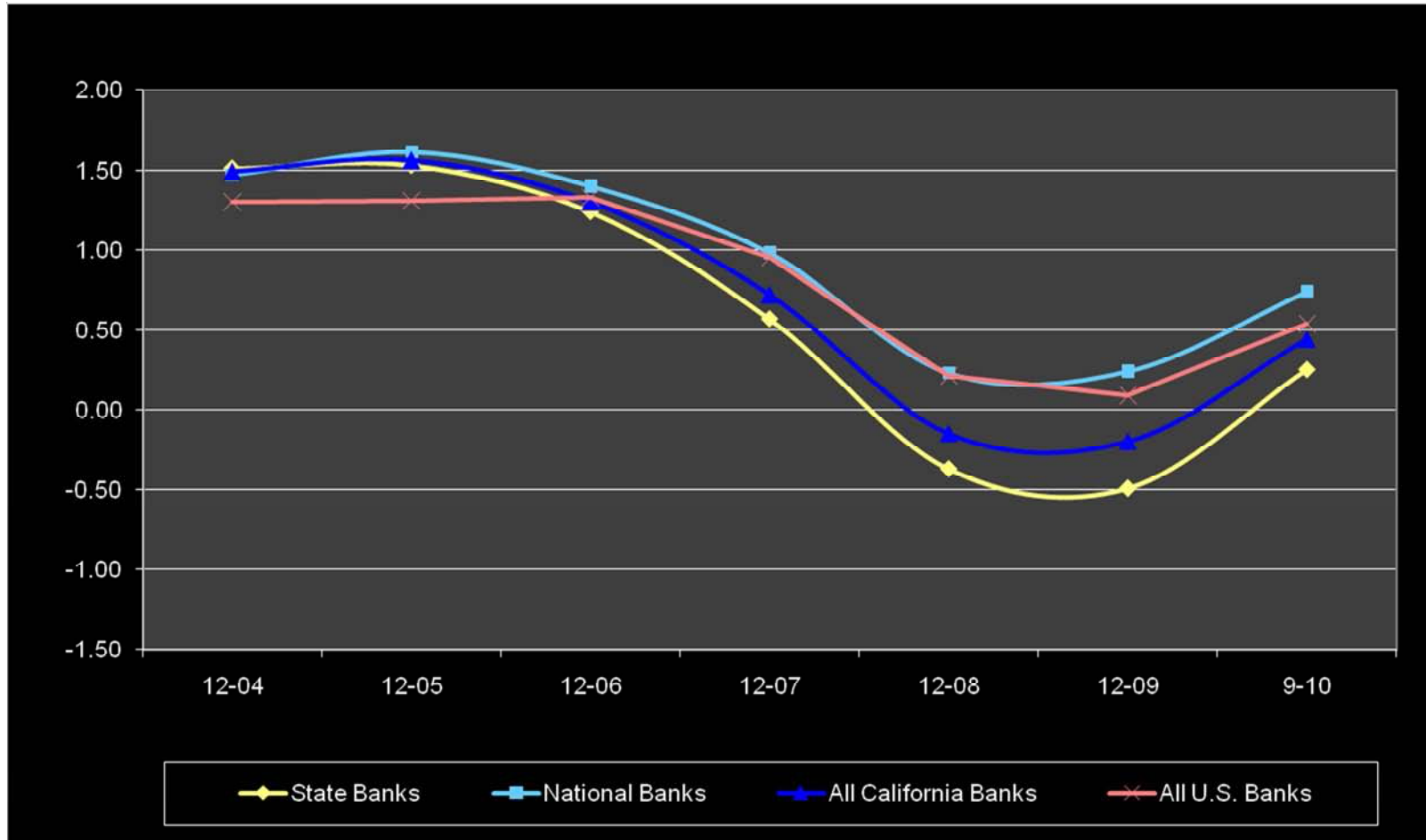
2010

Institution	Total assets (USD billions)	Assets as a percentage of GDP <sup>(d)</sup>	Assets as a percentage of total banking sector assets <sup>(b)(c)</sup> (percent)
Bank of America	2,363.9	16.7	19.7
JP Morgan	2,014.0	14.3	16.8
Citigroup	1,937.7	13.7	16.2
Wells Fargo	1,225.9	8.7	10.2
US Bancorp	283.2	2.0	2.4
PNC Financial Services	261.8	1.9	2.2
Bank of New York Mellon	235.9	1.7	2.0
Suntrust banks	170.7	1.2	1.4
BB&T corporation	155.1	1.1	1.3
State Street	160.7	1.1	1.3
<i>Total</i>	<b>8,809</b>	<b>62.4</b>	<b>73.6</b>

# Condition of CA Chartered Banks

- Q3 data show evidence of continuing improvement
  - Industry ROA up from Q2
  - % noncurrent loans/total loans down
  - Capital positions generally remain healthy, but ALLL/noncurrent loans looks thin
- Anticipate that bank failures in 2010 will be < 2009
- Pace of capital raises continues -- 9 banks completed offerings in Q3
- Expect industry consolidation via voluntary mergers for several years

# Return on Assets



# Return on Assets by Quintile\*

## State Chartered Commercial and Industrial Banks

**Annualized year-to-date through September 30, 2010**

Asset Size	Less than \$100MM	\$100 to \$500MM	\$500MM to \$2 Billion	\$2 Billion and More**	Total
Number of Banks	31	117	39	19	206
First Quintile	0.8	1.2	1.0	1.0	1.2
Second Quintile	0.1	0.6	0.6	0.7	0.6
Third Quintile	-0.9	0.3	0.4	0.3	0.3
Fourth Quintile	-2.4	-0.3	0.0	-0.4	-0.5
Fifth Quintile	-7.3	-2.2	-1.5		-3.4
Total	-2.0	0.1	-0.2	0.4	0.3

\* Quintiles of equal sizes are created by dropping off first the highest then the lowest ratio in each group until the number of institutions is divisible by 5.

\*\* Due to the small population in this category, it was divided into four equal sized groups.

# Noncurrent Loans & Leases / Total Loans & Leases by Quintile\*

## State Chartered Commercial and Industrial Banks

As of September 30, 2010

Asset Size	Less than \$100MM	\$100 to \$500MM	\$500MM to \$2 Billion	\$2 Billion and More**	Total
Number of Banks	31	117	39	19	206
First Quintile	9.6	9.4	7.9	5.6	9.3
Second Quintile	3.3	4.4	5.7	4.4	4.7
Third Quintile	0.9	2.7	3.7	3.6	2.9
Fourth Quintile	0.1	1.4	2.1	2.2	1.3
Fifth Quintile	0.0	0.3	0.7		0.2
Total	2.7	3.8	4.1	3.7	3.8

\* Quintiles of equal sizes are created by dropping off first the highest then the lowest ratio in each group until the number of institutions is divisible by 5.

\*\* Due to the small population in this category, it was divided into four equal sized groups.

# Tangible Equity Capital / Tangible Assets by Quintile\*

## State Chartered Commercial and Industrial Banks

**As of September 30, 2010**

Asset Size	Less than \$100MM	\$100 to \$500MM	\$500MM to \$2 Billion	\$2 Billion and More**	Total
Number of Banks	31	117	39	19	206
First Quintile	42.6	19.1	15.3	11.9	24.6
Second Quintile	16.4	12.7	12.0	10.3	12.6
Third Quintile	12.3	10.7	10.9	9.3	10.8
Fourth Quintile	10.1	9.8	10.3	8.0	9.8
Fifth Quintile	5.4	8.1	8.8		7.5
Total	16.6	11.9	12.6	10.1	10.8

\* Quintiles of equal sizes are created by dropping off first the highest then the lowest ratio in each group until the number of institutions is divisible by 5.

\*\* Due to the small population in this category, it was divided into four equal sized groups.

# Reserves for Loans / Noncurrent Loans & Leases by Quintile\*

## State Chartered Commercial and Industrial Banks

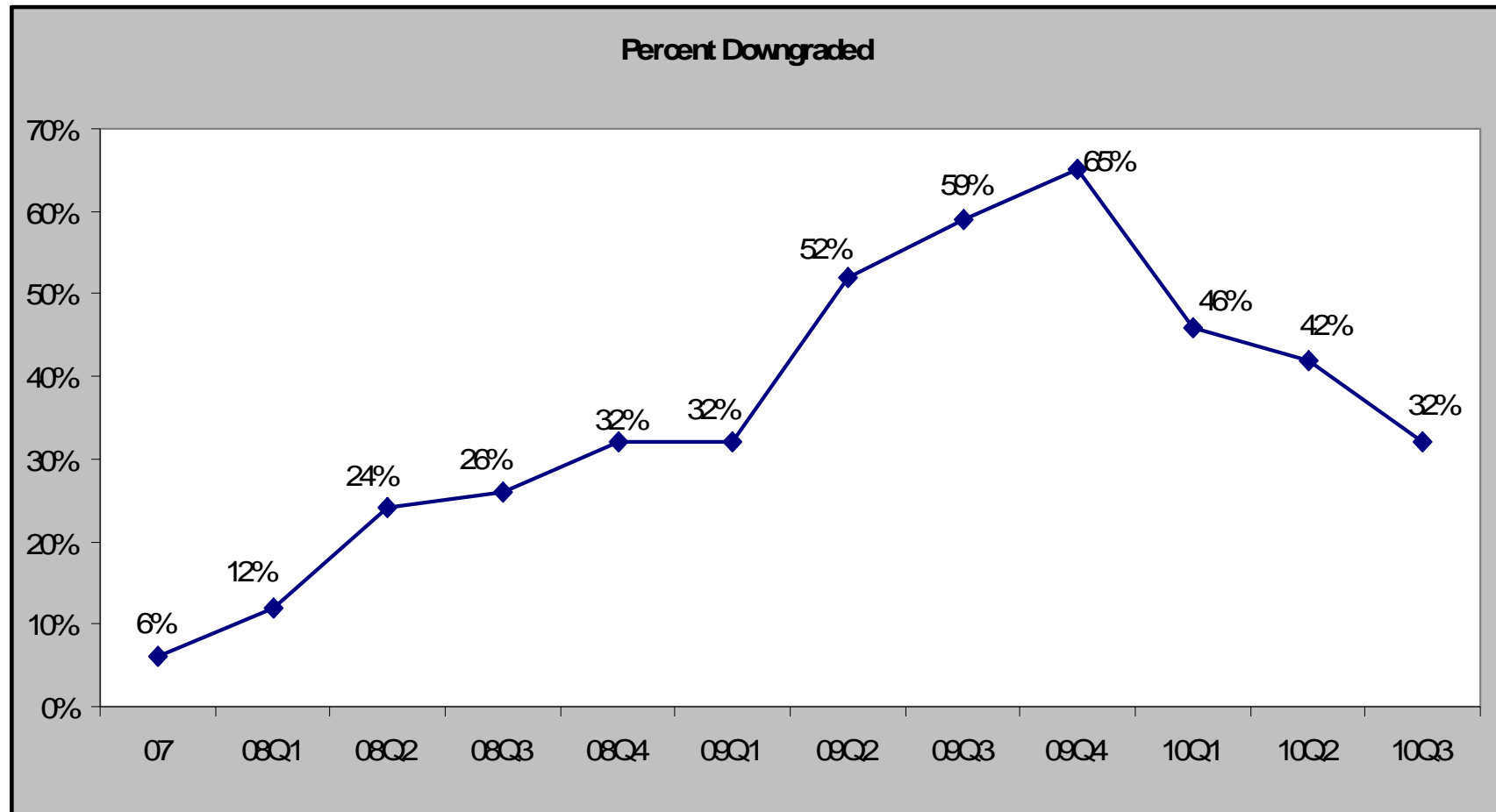
As of September 30, 2010

Asset Size	Less than \$100MM	\$100 to \$500MM	\$500MM to \$2 Billion	\$2 Billion and More**	Total
Number of Banks	31	117	39	19	206
First Quintile	∞	∞	475.9	96.4	∞
Second Quintile	∞	176.3	99.0	69.9	192.0
Third Quintile	388.1	90.9	67.5	54.0	85.3
Fourth Quintile	78.2	56.1	49.0	37.9	54.3
Fifth Quintile	33.2	35.0	33.2		31.8
Total	103.2	66.2	76.1	62.5	65.3

\* Quintiles of equal sizes are created by dropping off first the highest then the lowest ratio in each group until the number of institutions is divisible by 5.

\*\* Due to the small population in this category, it was divided into four equal sized groups.

# Downgrades Decelerating



# California Bank and Thrift Failures

## 2009 – Present

<u>Name</u>	<u>Type</u>	<u>City</u>	<u>Total Assets (000)*</u>	<u>Date Closed</u>
1st Centennial Bank	State	Redlands	797,959	1/23/09
Alliance Bank	State	Culver City	1,113,361	2/6/09
County Bank	State	Merced	1,711,552	2/6/09
First Bank of Beverly Hills	State	Calabasas	1,260,354	4/24/09
MetroPacific Bank	State	Irvine	75,316	6/26/09
Mirae Bank	State	Los Angeles	480,619	6/26/09
Temecula Valley Bank	State	Temecula	1,396,622	7/17/09
Vineyard Bank, N. A.	National	Rancho Cucamonga	1,638,378	7/17/09
Affinity Bank	State	Ventura	1,211,431	8/28/09
San Joaquin Bank	State	Bakersfield	766,359	10/16/09
California National Bank	National	Los Angeles	7,781,100	10/30/09
Pacific National Bank	National	San Francisco	2,319,263	10/30/09

\* Total assets are as of quarter-end prior to failure.

# California Bank and Thrift Failures

## 2009 – Present

<u>Name</u>	<u>Type</u>	<u>City</u>	<u>Total Assets (000)*</u>	<u>Date Closed</u>
San Diego National Bank	National	San Diego	3,594,544	10/30/09
United Commercial Bank	State	San Francisco	10,895,336	11/6/09
Pacific Coast National Bank	National	San Clemente	131,418	11/13/09
First Federal Bank of California	FSB	Santa Monica	6,143,903	12/18/09
Imperial Capital Bank	State	La Jolla	4,046,888	12/18/09
First Regional Bank	State	Los Angeles	2,082,684	1/29/10
La Jolla Bank, FSB	FSB	La Jolla	3,646,071	2/19/10
Innovative Bank	State	Oakland	268,891	4/16/10
Tamalpais Bank	State	San Rafael	628,903	4/16/10
1st Pacific Bank of California	State	San Diego	335,798	5/7/10
Granite Community Bank, N.A.	National	Granite Bay	102,913	5/28/10
Butte Community Bank	State	Chico	498,751	8/20/10

\* Total assets are as of quarter-end prior to failure.

# California Bank and Thrift Failures

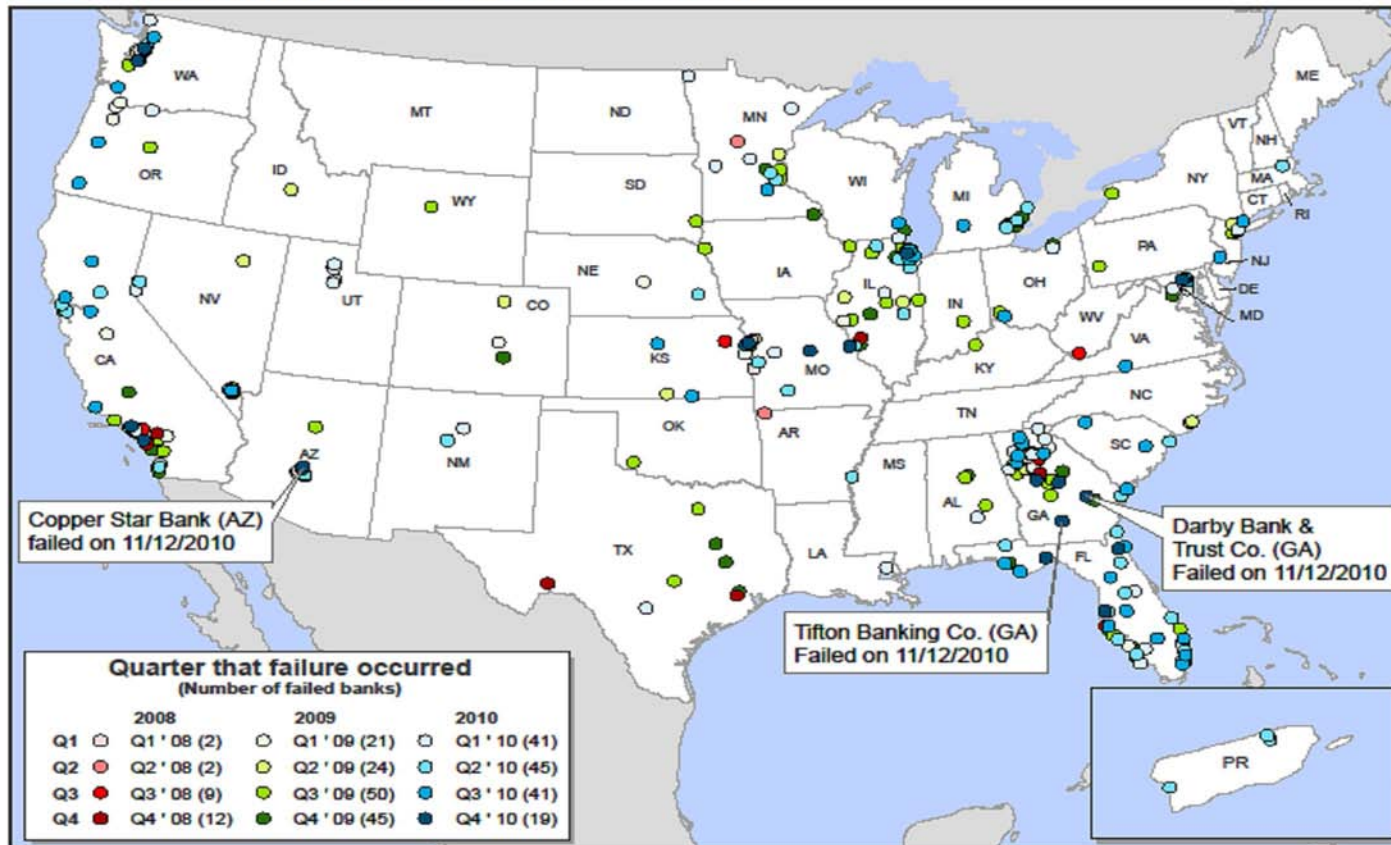
## 2009 – Present

<u>Name</u>	<u>Type</u>	<u>City</u>	<u>Total Assets (000)*</u>	<u>Date Closed</u>
Los Padres Bank	FSB	Solvang	901,516	8/20/10
Pacific State Bank	State	Stockton	312,077	8/20/10
Sonoma Valley Bank	State	Sonoma	337,113	8/20/10
First Vietnamese American Bank	State	Westminster	51,877	11/5/2010
Western Commercial Bank	State	Woodland Hills	110,603	11/5/2010
Total Bank Failures 2009:		#	17	
		\$	20,552,319	
Total Bank Failures YTD 2010		#	12	
		\$	9,277,197	

\* Total assets are as of quarter-end prior to failure.

# Bank and Thrift Failures Since 2008

**Bank and thrift failures since 2008**



As of: Nov 12, 2010  
Source: SNL Financial

# Equity Offerings by California State Chartered Banks Since 2009

- 34 state-chartered banks in California or their BHCs completed 69 equity offerings that raised \$4.4 billion.
- Number of completed offerings by CAMELS rating at the time of the offering:

<u>CAMELS</u>	<u>Rating at Offering Date</u>
1	0
2	16
3	23
4	25
5	3
<u>Unrated</u>	<u>2</u>
Total	69

Transaction Report  
Capital Purchase Program  
all California Banks  
for the period ending October 29, 2010

<u>Type of Bank</u>	<u>#</u>	<u>Total Purchase Amount</u>	<u>Total Capital Repayment Amount</u>	<u>Total Treasury CPP Investment Amount</u>
State Banks	53	1,948.8	489.0	1,459.8
National Banks*	15	686.7	402.6	284.1
Federal Savings Banks	4	46.5	4.9	41.6
<b>Total</b>	<b>72</b>	<b>\$2,682.0</b>	<b>\$896.5</b>	<b>\$1,785.5</b>

\* Excludes \$25 billion TARP investment in Wells Fargo & Company

# Changes Among State Banks 2005 – 2010

## Dollar Amounts in Thousands

	#	\$
Number of banks and total assets as of 1/1/05	189	172,470,243
# Failed	(19)	(32,524,524)
# Merged out of business	(39)	(15,934,679)
# Converted to national charter	(2)	(4,456,770)
# Ceased doing business	(2)	(7,666,124)
# Opened	71	38,571,392
# Converted to state charter	8	13,658,923
Change in assets of banks that acquired other banks	-	57,602,635
Change in assets of banks that did not acquire other banks	-	33,316,742
Number of banks and total assets as of 9/30/10	206	255,037,838
Net change 2005 - YTD 2010	17	82,567,595

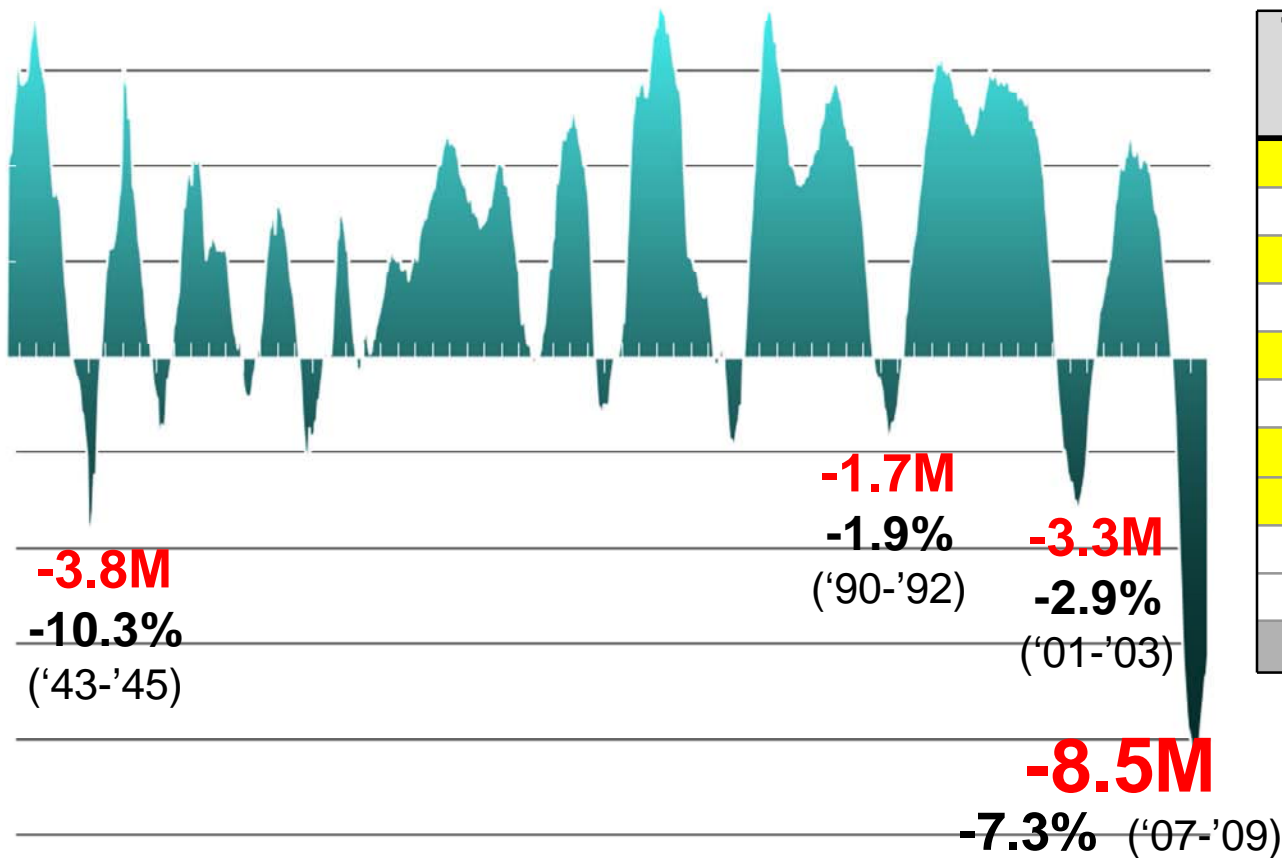
# Observations on the Outlook for the Economy, Credit and Banking

# Characteristics of Post-crisis Economies

- These are not normal cyclical events. Postwar U.S. experience with recessions and recoveries is not a good guide.
- Balance sheet damage from a collapse in valuations produces a slow, protracted recovery.
- Normal tools of monetary and fiscal policy less effective or unavailable.
- “Sovereign” risk and crises are part of the landscape.
- => Prepare for a Slow, Potentially Bumpy Recovery

# Two-Year Chg in Private Sector Jobs

U.S. –Chg in Private Nonfarm Jobs in 2 Year periods (000)



**Tot. Jobs Lost from Each State's Peak**  
(through Aug 2010)

1	NV	-14.1%
2	MI	-10.8%
3	AZ	-10.6%
4	FL	-10.4%
5	CA	-9.0%
6	RI	-9.0%
7	ID	-8.4%
8	OR	-8.2%
9	GA	-8.2%
10	OH	-7.6%
Nation		-5.8%

Shaded = 12<sup>th</sup> District states; state peaks occurred between 12/06 + 2/08

**"Great Recession":**  
12/07 – 6/09

Sources: Bureau of Labor Statistics, Haver Analytics, Seasonally Adjusted

## Best/Worst Metro Areas in U.S.

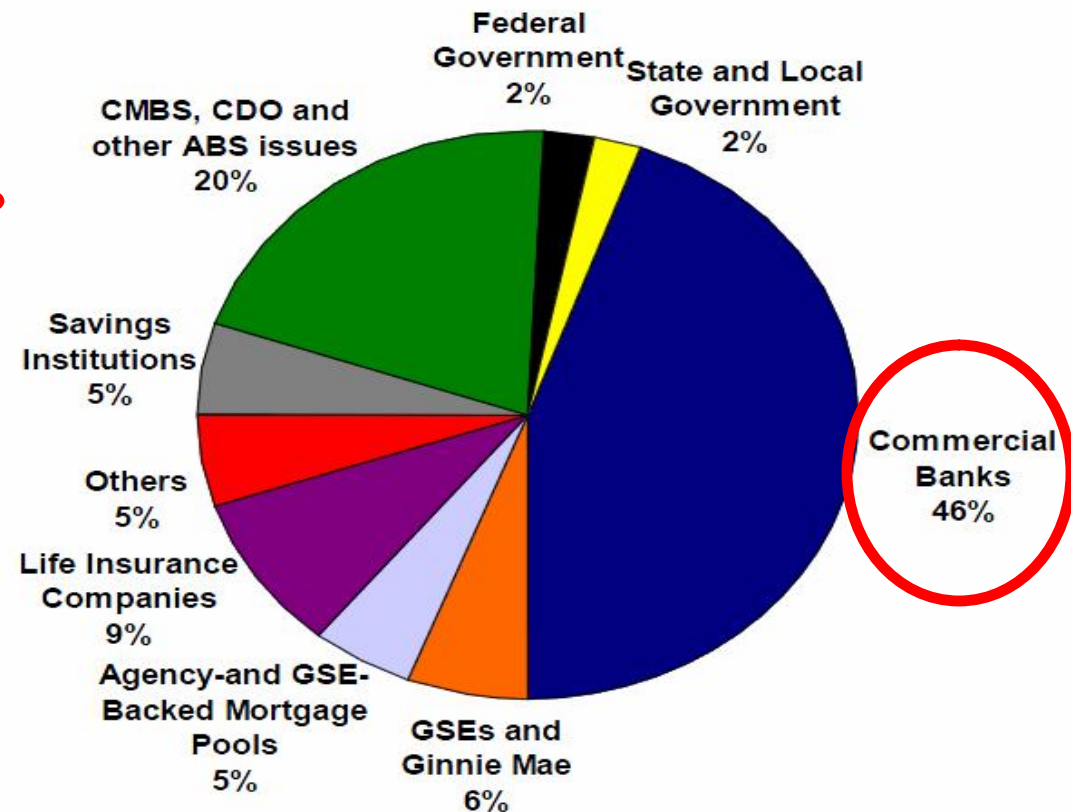
The 20 strongest-performing metro areas		The 20 weakest-performing metro areas	
Albany, NY	Jackson, MS	Boise City, ID	Oxnard, CA
Augusta, GA-SC	Kansas City, MO-KS	Cape Coral, FL	Palm Bay, FL
Austin, TX	Little Rock, AR	Detroit, MI	Phoenix, AZ
Baton Rouge, LA	Madison, WI	Fresno, CA	Providence, RI-MA
Buffalo, NY	McAllen, TX	Jacksonville, FL	Riverside, CA
Dallas, TX	Oklahoma City, OK	Las Vegas, NV	Sacramento, CA
Des Moines, IA	Omaha, NE-IA	Los Angeles, CA	Stockton, CA
El Paso, TX	Rochester, NY	Miami, FL	Tampa, FL
Honolulu, HI	San Antonio, TX	Modesto, CA	Toledo, OH
Houston, TX	Washington, DC-VA-MD-WV	North Port, FL	Youngstown, OH-PA

# Banks Account for \$1.5 trillion in CRE Loans

**Total Commercial/Multifamily Mortgage Debt Outstanding:  
\$3.38 trillion\***

## By Lender Types (\$Bil):

<b>Commercial Banks</b>	<b>\$1,506.3</b>
CMBS, CDO & Other ABS	\$690.5
Life Insurance Companies	\$307.4
GSEs and Ginnie Mae	\$197.8
Savings Institutions	\$183.8
Agency & GSE Pools	\$164.8
Federal Government	\$82.4
State & Local Government	\$77.5
Other	\$172.5

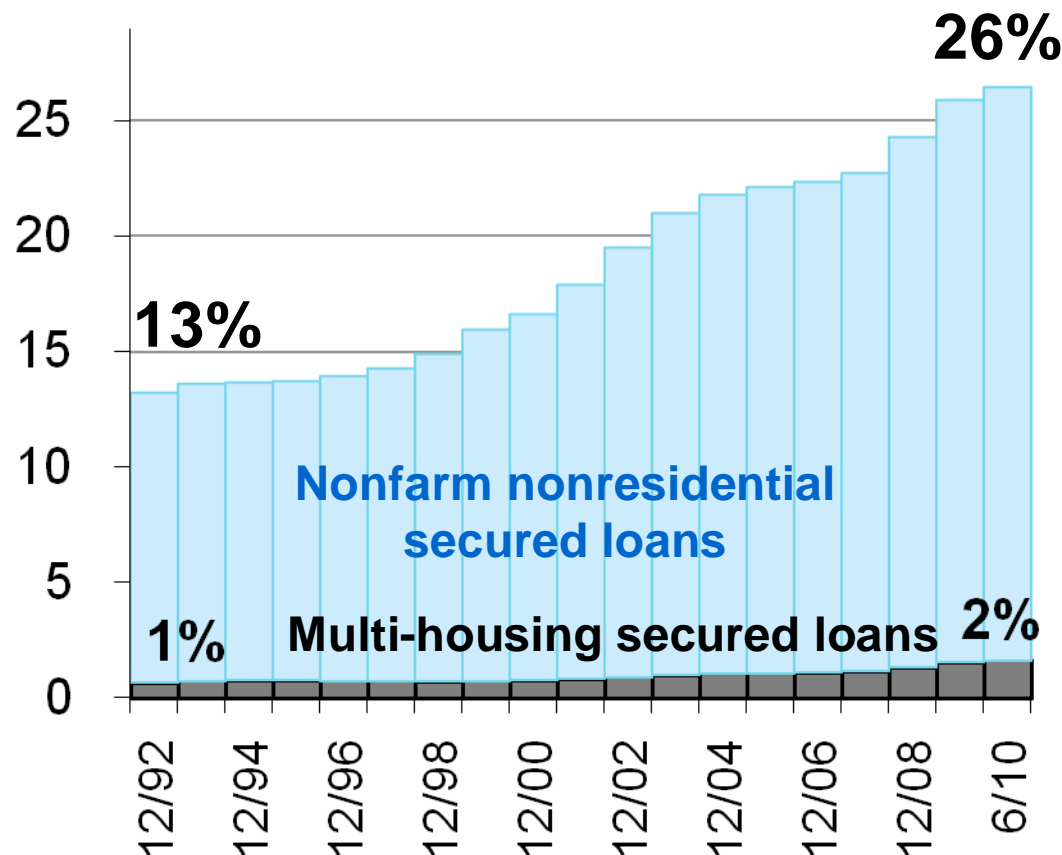


\* As of 4Q09

Sources: Marcus & Millichap Research Services, Mortgage Bankers Association

# Bank CRE Exposures

CRE Income Property Loans / Total Loans (national adj. avg. %)



NFNR Lns / Total Lns 06/10 (%)

Fed District	Avg.
San Franc	43%
Atlanta	32%
Richmond	31%
Philadelph	29%
New York	28%
Dallas	24%
Boston	24%
Cleveland	23%
St. Louis	23%
Chicago*	21%
Minneapolis*	20%
Kansas C*	18%

St	Avg.	rank
CA	48%	1
NV	47%	2
AZ	46%	3
FL	42%	4
OR	42%	5
AK	41%	6
DC	37%	7
NJ	36%	8
MD	36%	9
WA	36%	10
Nat	25%	

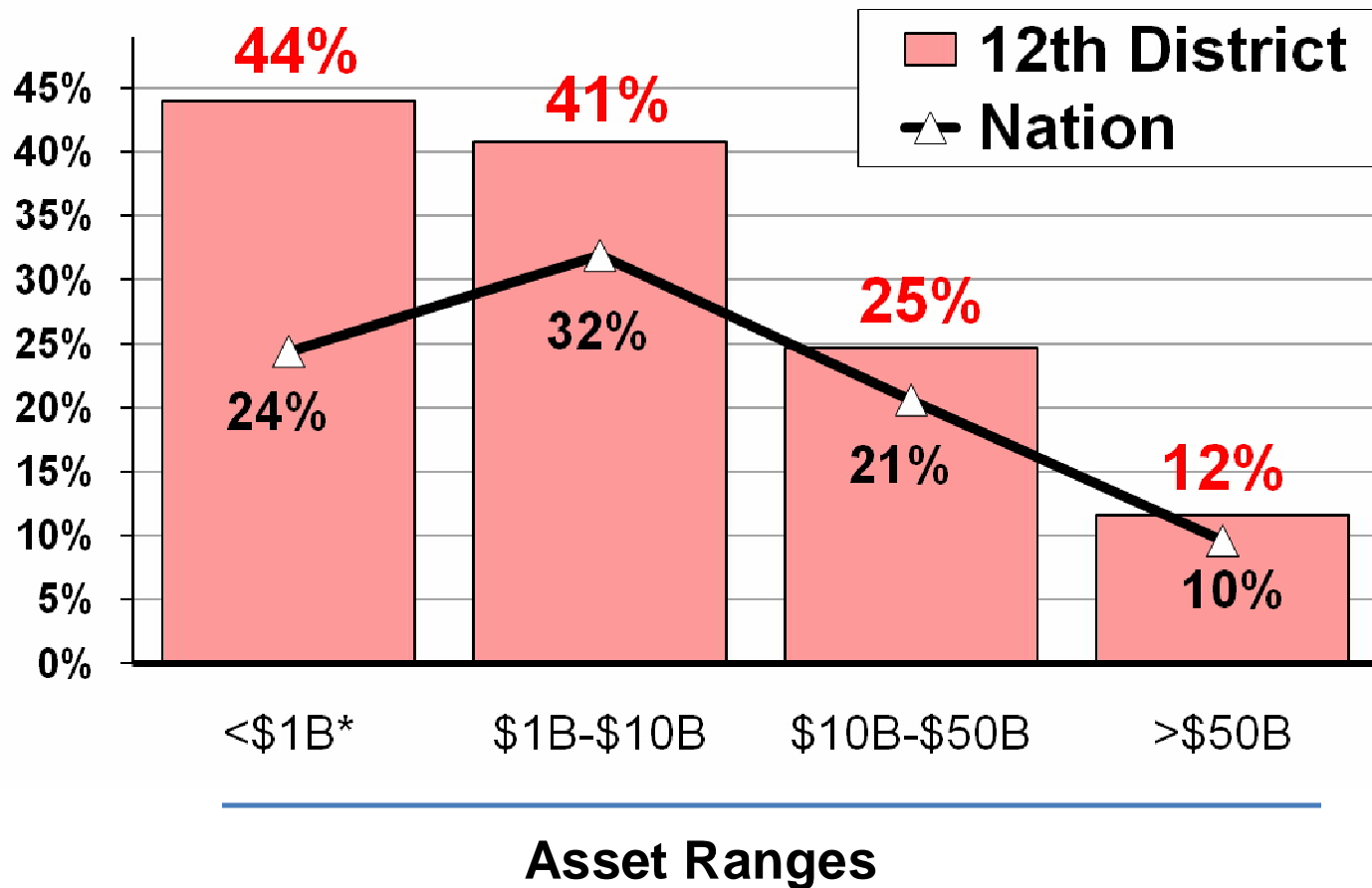
NFNR: Nonfarm nonresidential secured loans; Trimmed means for all commercial banks

\*NFNR excludes farmland-secured loans, which are highest, on average, in the Districts listed last

# CRE Exposures by Bank Size

*Smaller banks (under \$10B) have highest concentrations*

Nonfarm Nonresidential Loans / T. Loans – Adj. Averages for All Banks

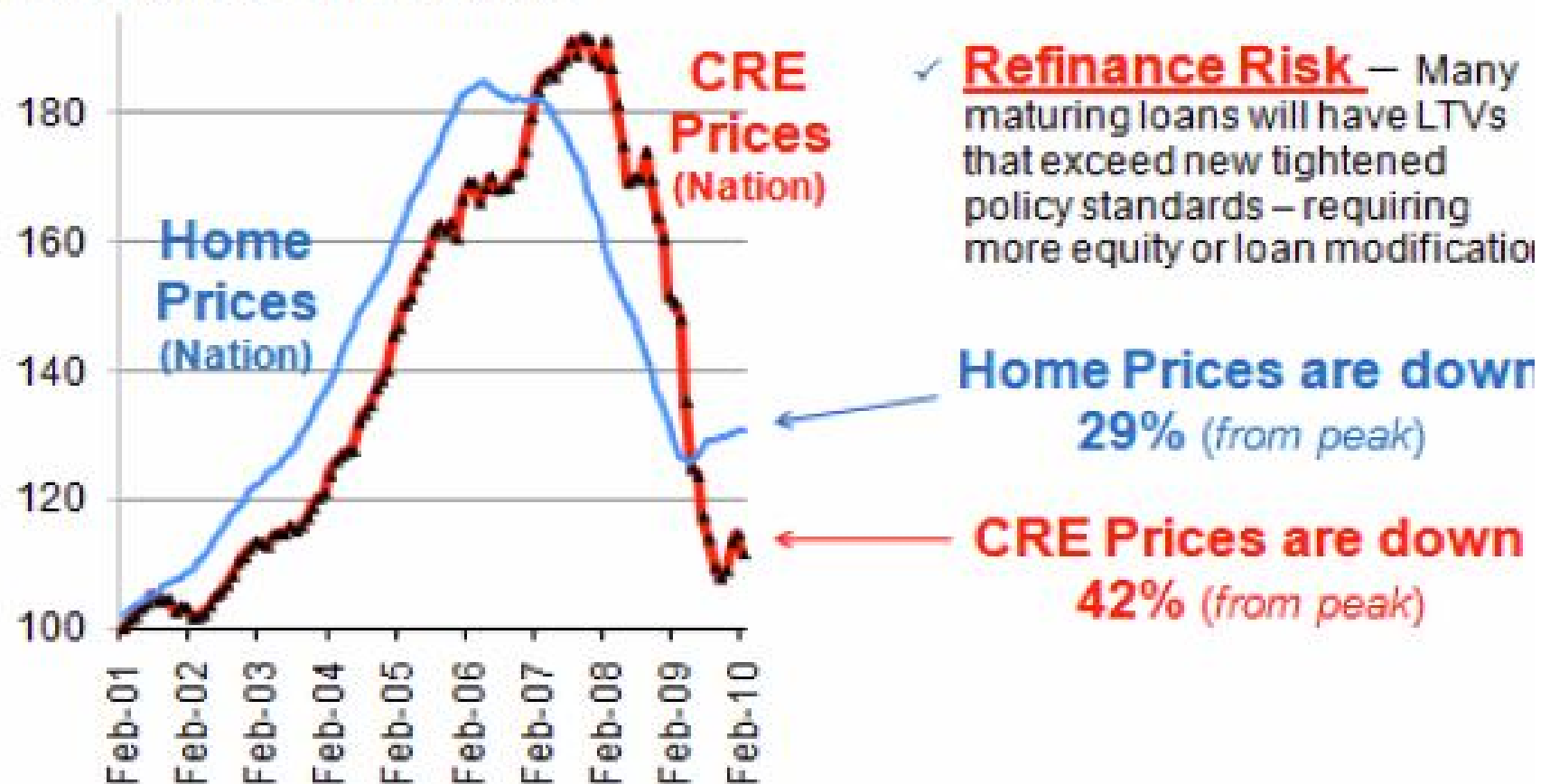


NFNR = Nonfarm Nonresidential secured loans; the <\$1B group excludes bank with assets under \$100M;  
Adjusted Avgs: Trimmed means

## 5) CRE Property Values Down Even More Than Housing

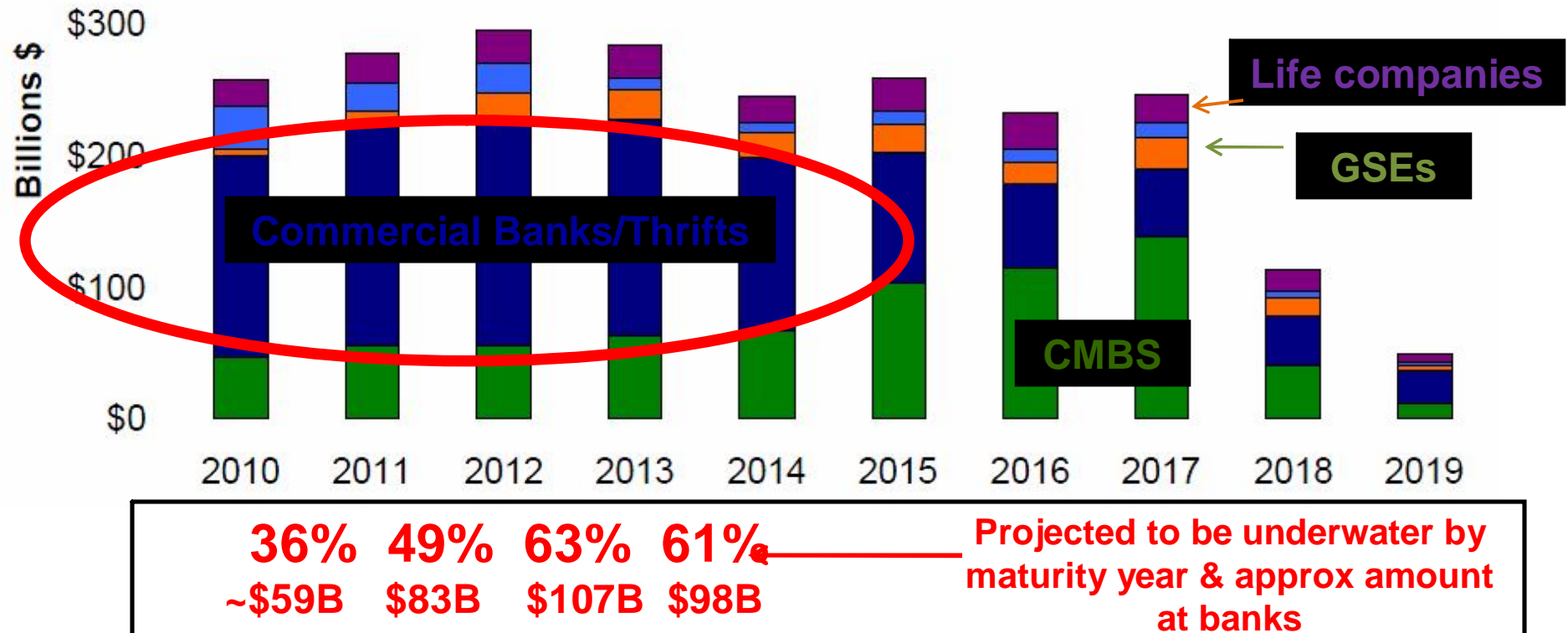
*Maturing CRE Loans Increasingly to Require Extensions & Restructuring*

Home and CRE Price Indices



Sources: Moody's/REAL Commercial Property Index; S&P Case-Shiller Home Price Composite 20 Index, SA; Haver Analytics; re-indexed to 100 at Dec 2000. Note: the CRE index is based on very few transactions -- the value decline may be overstated

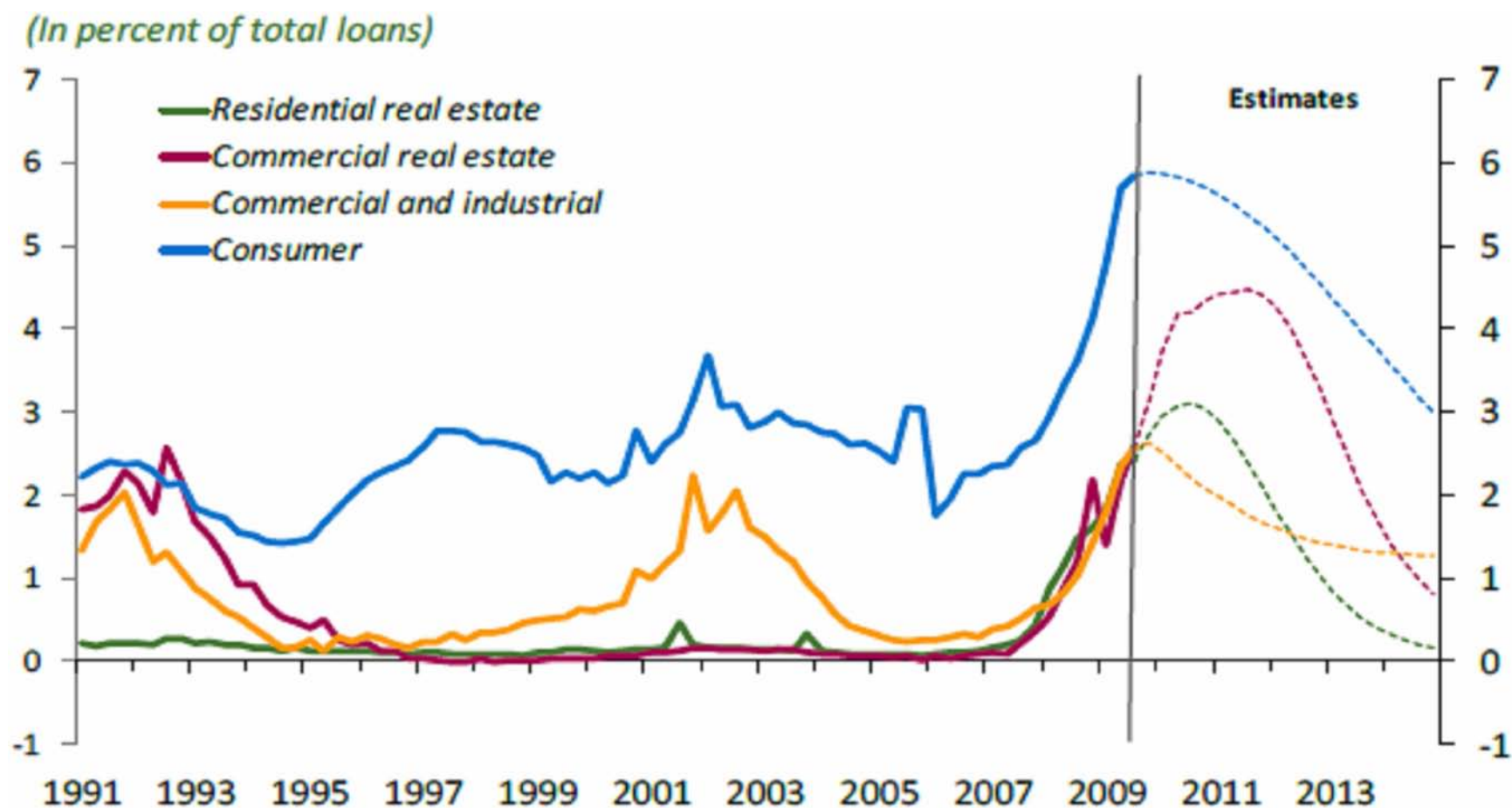
# Maturing CRE Loans – High Percent are Projected to be Underwater *Includes C&LD and other CRE loans*



✓ **High Refinance Risk** — Many maturing loans will have LTVs that exceed new tightened policy standards – requiring more equity or loan modification

Sources: Foresight Analytics, Marcus & Millichap

# U.S. Loan Charge-Off Rates (Including IMF Forecasts)



Sources: Federal Reserve; and IMF staff estimates.

## Back to the Future?

### California Banking in the 1930s

- *“the combined statements submitted herewith give a factual demonstration of the urgent problem faced uniformly by all banks--earning assets in the form of good loans are not available in sufficient amounts to take up the increase in deposits. The only outlet is government bonds at extremely low rates--in fact lower than the prevailing rates on time deposits... Even the acquisition of government bonds on a low yield basis may cause future embarrassment should prevailing rates increase due either to declining public confidence in government issues or to the flotation of more attractive private issues.”*

Superintendent Friend William Richardson, 1934

Where Do We Go from Here with Bank  
Regulation and Supervision?

# Impact of Dodd-Frank + Heightened Regulatory Expectations

- Dodd-Frank will touch every corner of the financial system, but its biggest impact will be on largest financial institutions.
- Direct and indirect impacts on community and regional banks are difficult to assess at this time.
  - Key provisions: increase in deposit insurance coverage now permanent, interest payable on DDA, Fed to regulate interchange fees
- CFPB creates major new uncertainties.
- Roll-back of OCC's preemption authority invites new state-level consumer financial legislation.
- Basle III initiative could be at least as significant as Dodd-Frank and should be watched closely.

# Financial Stability Oversight Council -- Purposes

- To identify risks to financial stability that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected BHCs or nonbanks.
- To promote market discipline by eliminating expectations on the part of shareholders, creditors and counterparties...that the government will shield them from losses in the event of failure.
- To respond to emerging threats to financial stability

# Financial Stability Oversight Council Membership

## Voting

- Secretary of the Treasury
- Chair of FRB
- Comptroller
- Director of CFPB
- Chair of SEC
- Chair of FDIC
- Chair of CFTC
- Director of FHFA
- Chair of NCUA
- Insurance representative appointed by President

## Nonvoting

- Director of office of financial research
- Director of federal insurance office
- State insurance commissioner
- State banking commissioner
- State securities commissioner

# Financial Stability Oversight Council -- Duties

- Information gathering and sharing
- Recommending supervisory priorities/prudential standards
- Identifying gaps in regulation
- Identify nonbank FIs that may pose risks to the financial system for supervision by FRB
- Identify systemically important financial utilities and payment, clearing and settlement activities
- Reporting to Congress & testimony by Chair annually
- Statements by voting members

# A Lesson Learned from the Crisis

- The key differentiator between successful and failed banks is the quality of management and board oversight.
- **But** the “M” component rating became a lagging indicator of a bank’s condition, not an independent rating of management.
- Internal DFI reviews and FDIC OIG reports of failed banks demonstrate that examiners identified management weaknesses well before failure occurred, but these weaknesses were not reflected in the management component rating so long as the bank was profitable and nonperforming assets were low.

## The “M” in CAMELS

- *The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating.*

Uniform Financial Institutions Ratings System  
1996

# The Traditional Emphasis

- *A bank's performance with respect to asset quality and diversification, capital adequacy, earnings performance and trends, liquidity and funds management, and sensitivity to fluctuations in market interest rates is, to a very significant extent, a result of decisions made by the bank's directors and officers. Consequently, findings and conclusions in regard to the other five elements of the CAMELS rating system are often major determinants of the management rating.*

Uniform Financial Institutions Ratings System  
Revised 1996

## A Better Emphasis

1. Does the bank have effective board oversight and corporate governance practices, policies and procedures?
2. Does the bank have an effective framework for risk management consistent with its size, complexity, structure and risk profile?
3. How well do the board, management and control functions execute against this framework?

# Common Governance Weaknesses

- Board lacks experienced, capable financial professionals with knowledge of regulations/guidance.
- Board is dysfunction (e.g., factional, distrustful, dominated by an individual or small group, unengaged, unprepared, etc.)
- Board is too trusting of the CEO & management. Dominant CEO controls the bank.
- Lack of formalized processes for management evaluations – both management structures and executive competencies. Board relies excessively on regulatory assessments of management.
- Lack of independence of the risk management functions.
- Weak or inactive risk committee structures at board and management levels.

# Common Weakness in the Risk Framework

- Emphasis is on ROE without adequate consideration of risk factors. Board does not articulate risk appetite or set risk limits in a meaningful/measurable way.
- Compensation plans incent growth or short-run returns.
- Risk management function lacks leadership or support from the Board/CEO and/or lacks independence from revenue generating officers and units.
- Inadequate resources. Poor MIS. Inadequate analytical capabilities for stress testing/scenario analysis.
- Failure to recognize and control interrelated risks.
- Audit functions not independent of management.

# Common Weaknesses in Risk Management Execution

- Failure to stay within prescribed policy limits. Exceptions to risk limits granted to meet competition.
- Inadequate communication flows.
- Ineffective oversight and controls.
- Inadequate credit underwriting standards/credit administration function.
- Excessive reliance on third parties' risk assessments (e.g., credit rating agencies, lead bank for loan participations).
- Failure to implement audit recommendations.
- Lack of accountability.

